

2008 and 2007 TAX RATES, EXEMPTION & STANDARD DEDUCTION

2008 PERSONAL EXEMPTIONS

\$3,500 (\$3,400 in 2007) each for taxpayer, spouse and qualified dependent.

See reverse side if AGI exceeds \$239,950 on a joint or \$159,950 on a single return.

Dependent on another's return: no exemption.

STANDARD DEDUCTION

<u>Filing Status</u>	<u>2007</u>	<u>2008</u>
Joint and surviving spouse	\$10,700	\$10,900
Single	5,350	5,450
Head of household	7,850	8,000
Married filing separately	5,350	5,450

Dependent on another's return: standard deduction limited to the greater of: (a) \$900, or
(b) earned income plus \$300, but cannot exceed the \$5,450 maximum for a single person.

Over 64 and/or blind: add \$1,050 for each condition on a joint return; \$1,350 for each on a single return.

ITEMIZED DEDUCTION PHASEOUT: 1% of the amount that AGI exceeds \$159,950 (for all taxpayers).

2007 TAX RATE SCHEDULES

<u>Taxable Income over</u>	<u>but not over</u>	<u>Tax is</u>	<u>Plus %</u>	<u>of excess over</u>
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JOINT

0	15,650		10%	0
15,650	63,700	1,565.00	+ 15%	15,650
63,700	128,500	8,772.50	+ 25%	63,700
128,500	195,850	24,972.50	+ 28%	128,500
195,850	349,700	43,830.50	+ 33%	195,800
349,700		94,601.00	+ 35%	349,700

SINGLE

0	7,825		10%	0
7,825	31,850	782.50	+ 15%	7,825
31,850	77,100	4,386.25	+ 25%	31,850
77,100	160,850	15,698.75	+ 28%	77,100
160,850	349,700	39,148.75	+ 33%	160,850
349,700		101,469.25	+ 35%	349,700

HEAD OF HOUSEHOLD

0	11,200		10%	0
11,200	42,650	1,120.00	+ 15%	10,450
42,650	110,100	5,837.50	+ 25%	42,650
110,100	178,300	22,700.00	+ 28%	110,100
178,300	349,700	41,810.00	+ 33%	178,300
349,700		98,355.50	+ 35%	349,700

MARRIED FILING SEPARATELY

0	7,550		10%	0
7,550	30,650	755.00	+ 15%	7,550
30,650	61,850	4,220.00	+ 25%	30,650
61,850	94,225	12,020.00	+ 28%	61,850
94,225	168,275	21,085.00	+ 33%	94,225
168,275		45,521.50	+ 35%	168,275

2008 TAX RATE SCHEDULES

<u>Taxable Income over</u>	<u>but not over</u>	<u>Tax is</u>	<u>Plus %</u>	<u>of excess over</u>
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JOINT

0	16,050		10%	0
16,050	65,100	1,605.00	+ 15%	16,050
65,100	131,450	8,962.50	+ 25%	65,100
131,450	200,300	25,550.00	+ 28%	131,450
200,300	357,700	44,828.00	+ 33%	200,300
357,700		96,770.00	+ 35%	357,700

SINGLE

0	8,025		10%	0
8,025	32,550	802.50	+ 15%	8,025
32,550	78,850	4,481.25	+ 25%	32,550
78,850	164,550	16,056.25	+ 28%	78,850
164,550	357,700	40,052.25	+ 33%	164,550
357,700		103,791.75	+ 35%	357,700

HEAD OF HOUSEHOLD

0	11,450		10%	0
11,450	43,650	1,145.00	+ 15%	11,450
43,650	112,650	5,975.00	+ 25%	43,650
112,650	182,400	23,225.00	+ 28%	112,650
182,400	357,700	42,755.00	+ 33%	182,400
357,700		100,604.00	+ 35%	357,700

MARRIED FILING SEPARATELY

0	8,025		10%	0
8,025	32,550	802.50	+ 15%	8,025
32,550	65,725	4,481.25	+ 25%	32,550
65,725	100,150	12,775.00	+ 28%	65,725
100,150	178,850	22,414.00	+ 33%	100,150
178,850		48,385.00	+ 35%	178,850

INTERNAL REVENUE CODE SECTIONS (for the course)

§ RATES & CREDITS

- 1 tax rate schedules
- 2 filing status
- 21 dependent care credit
- 23 adoption credit
- 24 child tax credit
- 25A Hope and Lifetime Learning credits
- 32 earned income tax credit (EITC)
- 63 taxable income and standard deduction
- 67 2% floor on miscellaneous itemized deductions
- 68 overall limit on itemized deductions
- 143 marital status

GROSS INCOME

- 61 gross income
- 62 adjustments
- 71 alimony
- 72 annuities
- 74 prizes and awards

EXCLUSIONS

- 101 life insurance
- 102 gifts and inheritances
- 103 tax-exempt interest
- 104 recoveries for injuries and sickness
- 105 health insurance benefits
- 106 employer contributions to health plans
- 108 discharge of debt
- 117 scholarships and fellowships
- 119 meals and lodging
- 121 gain from sale of principal residence
- 127 educational assistance plans
- 129 dependent care assistance programs
- 132 fringe benefits

EXEMPTIONS

- 151 personal exemptions
- 152 definition of dependent

DEDUCTIONS

- 67 2% floor on miscellaneous deductions
- 162 trade or business expenses
- 163 interest
- 164 taxes
- 165 losses
- 166 bad debts
- 167 depreciation
- 168 MACRS (and bonus depreciation)
- 170 charitable contributions
- 179 first-year expensing

INTERNAL REVENUE CODE SECTIONS Continued

DEDUCTIONS continued

- 183 activities not engaged in for profit (“hobby losses”)
- 195 start-up expenses
- 212 expenses for production of income
- 213 medical expenses
- 215 alimony
- 217 moving expenses
- 221 interest on educational loans
- 222 qualified tuition and related expenses

LIMITATIONS ON DEDUCTIONS

- 262 personal expenses
- 263 capital expenditures
- 265 expenses related to tax exempt income
- 267 losses between related parties
- 274 disallowance of some entertainment and other expenses
- 275 disallowance of deduction for federal income tax
- 280A deduction of residence (home office)
- 465 at-risk rules
- 469 passive loss rules

DISPOSITION OF PROPERTY

Basis Rules

- 1001 definition of gain or loss
- 1011 adjusted basis
- 1012 cost basis
- 1014 property acquired from decedent
- 1015 property acquired by gift
- 1016 adjustments to basis

Nonrecognition Provisions

- 1031 tax-free exchanges
- 1033 deferral of gain on involuntary conversions
- 1041 transfer of property between spouses
- 1091 wash sales

Capital Gains and Losses

- 1(h) maximum capital gains rate
- 1091 wash sales
- 1211 capital loss limitations
- 1212 capital loss carryover
- 1221 definition of capital asset
- 1222 capital transactions
- 1223 holding period rules
- 1244 loss on small business stock

2008 PHASEOUT AMOUNTS

DEDUCTIONS

itemized deductions

phased out by 2% of the amount that AGI exceeds **\$159,950**

personal exemptions

phased out as AGI exceeds **\$159,950** on single returns; **\$239,950** on joint returns if AGI exceeds those amounts; use h/o 1A

§ 221 student loan interest deduction

\$2,500 maximum deduction is phased out over:

§ 221 MAGI **\$55,000-\$70,000** on a single return

§ 221 MAGI **\$115,000-\$145,000** on a joint return

§ 222 tuition deduction

\$4,000 if § 222 MAGI does not exceed **\$65,000** on a single return; **\$130,000** on a joint return;

\$2,000 if § 222 MAGI exceeds those amounts but does not exceed **\$80,000** or **\$160,000**, respectively

real estate passive loss

\$25,000 real estate passive loss deduction is phased out over MAGI **\$100,000 - \$150,000**

CREDITS

Hope and Lifetime Learning (LLC) credits

phased out over AGI range of **\$48,000-\$58,000** on a single return; **\$96,000-\$116,000** on a joint return.

child tax credit

phased out by \$50 for each \$1,000 (or fraction of \$1,000) that AGI exceeds **\$75,000** on a single return; **\$110,000** on a joint return

TAX TERMINOLOGY

Total Receipts: the fair market value of all money, property and services received during the year.

Exclusions: receipts that the Code excludes from gross income, including gifts, scholarships, inheritances, and damage awards for personal physical injuries.

Gross Income: total receipts minus exclusions

Deductions: Expenditures and statutory amounts the taxpayer deducts from gross income to arrive at taxable income. There are several types of deductions:

adjustments: Expenditures such as business expenses and alimony subtracted from gross income to arrive at adjusted gross income (AGI). These deductions are referred to as “above the line” deductions.

Adjusted Gross Income (AGI) (“the line”) is gross income minus adjustments. AGI is used to measure the deductibility of other deductions.

itemized deductions: Expenditures, such as mortgage interest, real estate taxes and charitable expenses, the taxpayer deducts from AGI. They are “below the line” deductions because they are subtracted from AGI.

standard deduction: A statutory amount a taxpayer deducts from AGI, if itemized deductions are less than the standard deduction. The 2008 standard deduction on a joint return is \$10,900 and \$5,450 on a single return.

exemptions: A statutory amount (\$3,500 in 2008) the taxpayer deducts for himself, his spouse, and each qualified dependent.

Taxable Income: (gross income minus all deductions) is the amount on which the tax is calculated

Credits: amounts that are subtracted directly from the tax, such as the Lifetime Learning credit.

A BRIEF TAX HISTORY

- 1981 Reagan took office and encouraged Congress to pass the **Economic Recovery Tax Act of 1981** that lowered all tax rates and reduced the highest rate from 70% to **50%**. This Act is credited for helping the economy begin almost 20 years of growth.
- 1986 The **Tax Reform Act of 1986** made fundamental changes to Internal Revenue Code. It reduced all rates to **15% or 28%** and eliminated many deductions to make up for the steep decline in rates. Many provisions of this Act are still important and I will refer to them frequently during the course.
- 1990-3 The highest tax rate was increased to **31%** in 1990, and as budget deficits continued to expand, so Congress added **36%** and to **39.6%** brackets in 1993.
- 2001 **Economic Growth and Tax Relief Act of 2001 (expires 12/31/2010)**
President Bush encouraged Congress to pass this major tax reduction bill, which reduced all tax rates over a 5-year period and provided many new tax benefits. The maximum tax rate was reduced from 50% to 35%. To help offset rate reductions, the Act contained a complicated array of phase-in rules and effective dates.
- 2003 **Jobs and Growth Tax Relief Reconciliation Act of 2003** accelerated many 2001 Act reductions that were not scheduled to take effect until 2006 and included several new provisions, such as reducing the maximum tax on long-term capital gains from 20% to 15%. Some provisions were temporary, expiring in 2004 or 2005. The result was a revolving door of tax rates and other changes between 2003 and 2010 that made tax planning difficult.
- 2004 **Working Families Tax Relief Act of 2004** extended several provisions of the 2001 and 2003 Acts scheduled to expire in 2004. The “marriage penalty” relief provisions were extended through 2010 and other provisions through 2005.
- 2006 **Tax Increase Prevention and Reconciliation Act of 2005** For budgetary reasons, some provisions of the 2001 and 2003 Acts expired in 2005 and others were scheduled to expire over the next few years. This act extended some tax cuts for a few more years, including reduced rates on capital gains.
- 2006 **Tax Relief and Health Care Act of 2006** extended the rest of the provisions scheduled to expire in 2005. The extensions were retroactive to January 1, 2006; some provisions were extended for one year, others for two years.
- 2007 **Small Business and Work Opportunity Act of 2007** increased the “kiddie tax” age (when a child’s interest and dividends greater than \$1,800 are taxed at the parent’s rate) from under 18 to under 19 (or under 24 if the child is a full-time student).
- Tax Increase Prevention Act of 2007** extended expiring tax deductions and increased the Alternative Minimum Tax exemption for 2007.
- Mortgage Forgiveness Debt Relief Act of 2007** excludes from gross income certain forgiveness of mortgage debt for a personal residence and limits the exclusion of gain for the sale of a principal residence.
- The Tax Reduction and Reform Act of 2007**, the Democrats’ major tax overhaul plan was introduced, but not expected to pass. If the Democrats win the White House, it may forecast the type of changes they will attempt to enact.

CHAPTER 4 BASIS EXAMPLE

1. Taxpayer purchased a condo for \$150,000:

cash	\$ 30,000
mortgage loan	<u>120,000</u>
adjusted basis	\$150,000

2. Remodels the kitchen for \$5,000 cash + 5,000
adjusted basis \$155,000

3. Pays \$10,000 of loan principal, reducing the loan balance to \$110,000. This has no effect on the basis.

4. Sells condo for \$200,000; \$110,000 of the proceeds is used to pay the loan balance and receives the \$90,000 balance. The amount realized is \$200,000, the amount she received plus the amount used to pay the debt.

Tax Gain on Sale

amount realized	\$200,000
- adjusted basis	<u>- 155,000</u>
equals tax gain	<u>\$ 45,000</u>

Economic Gain on the Transaction

cash received at closing	\$90,000
minus cash invested:	
down payment	\$30,000
plus remodeling expense	5,000
loan principal paid	<u>10,000</u>
total cash invested	\$45,000
	<u>- 45,000</u>
equals economic gain on transaction	<u>\$45,000</u>

In transactions between unrelated parties, the tax gain should equal the economic gain.

TAX CONSEQUENCES OF TAXABLE EXCHANGES

The *Philadelphia Park Amusement* Rule

Tax transactions often involve an exchange of property between two taxpayers, as in the example in the middle of casebook page 88. In an exchange transaction, each taxpayer must determine (1) the gain or loss realized on the property being disposed of, and (2) the basis of the property received. It helps to diagram the facts of an exchange as shown in the following example so you can visualize it.

Example on Casebook page 88

Joe agrees to exchange his 100 shares of XYZ Co. for George's 100 shares of ABC Co. Joe's basis in the XYZ stock was \$5,000 and the stock was worth \$10,000 at the time of the exchange. George's basis in the ABC stock was \$12,500 and the stock was worth \$10,000 at the time of the exchange.

<u>Joe</u>		<u>George</u>	
XYZ stock	\$ 10,000	ABC stock	\$ 10,000
basis	5,000	basis	12,500

Analyze each taxpayer's situation separately, beginning with Joe. He disposed of his XYZ stock and received George's ABC stock. Joe realized a \$5,000 gain on the exchange, measured by the difference between the \$10,000 FMV of the ABC stock he received (the "amount realized") and the \$5,000 basis of the XYZ stock he exchanged. What is Joe's basis in the ABC stock he received? \$10,000. The *Philadelphia Park Amusement* rule states that **the basis of property received in a taxable exchange is its FMV on the date of the exchange**. Joe's basis in the ABC stock is \$10,000, its FMV on the date of the exchange.

George realized a \$2,500 loss on the disposition of his ABC stock, the difference between the \$10,000 FMV of the XYZ shares he received and the \$12,500 basis of the ABC stock he exchanged. George's basis in the XYZ stock is \$10,000, its FMV on the date of the exchange.

The *Philadelphia Park* basis rule gives you the same result as the "tax cost basis" rule discussed on casebook page 85. When the employer gave the employee a \$5,000 car, it is considered a taxable exchange. The employee received the car because of the employment relationship. The employee "exchanged" \$5,000 of services for the car and the tax result should be the same whether an employer pays an employee \$5,000 in cash or a \$5,000 car: the employee has \$5,000 of compensation income. The employee's basis in the car is \$5,000, the FMV on the date of the exchange, using the *Philadelphia Park Amusement* rule.

Keeping Score: The Tax Gain Should Equal the Economic Gain

The role of basis in tax law is to make sure the taxpayer's gain (or loss) for tax purposes equals the actual economic gain (or loss) on the transaction. Look back at Joe in the above example. If he sells his ABC stock two years later for \$13,000, he will realize a \$3,000 gain (\$13,000 amount realized minus \$10,000 basis). Joe started with XYZ stock he bought for \$5,000. He ended with \$13,000 after he sold the ABC stock. His economic gain is \$8,000 (\$13,000 proceeds from the sale of ABC minus \$5,000 cost of XYZ stock). His tax gain is also \$8,000. He realized a \$5,000 gain when he exchanged XYZ for ABC stock and another \$3,000 gain when he sold ABC for \$13,000.

PHILADELPHIA PARK AMUSEMENT PROBLEMS

The purpose of the following problems is to illustrate that the *Philadelphia Park* rule works to get the correct tax result. In problem 1, one property declined in value by the date of the exchange, but the parties are obligated to complete the transaction. Diagram the facts so you can visualize the transaction and use the *Philadelphia Park* rule to answer the questions. You will see that the economic gain will equal the tax gain if you use the *Philadelphia Park* rule. The solution to problem 1 is on the next page.

Problem 1

In 2004, Belcor bought a diamond necklace for \$1,000 and Filler bought a gold chain for \$500. On January 12, 2008, when each item was worth \$2,000, they contracted to exchange their necklace and chain with each other. By the time they exchanged the jewelry on November 1, 2008, Belcor's necklace was worth only \$1,800. Answer the following questions and try to prove the result.

- (a) What is Belcor's gain on the disposition of the necklace?
- (b) What is Belcor's basis for the chain?
- (c) What is Filler's gain on the disposition of the chain?
- (d) What is Filler's basis for the necklace?
- (e) If Belcor sells the chain for \$5,000, how much is the gain?
- (f) If Filler sells the necklace for \$6,000, how much is the gain?

Problem 2

Bauer is a sales associate in an antique store. He purchased a \$10,000 desk from the store in 2008, but paid only \$9,000 because he is entitled to a 10% employee discount. (You will learn in Chapter 11 that § 132(a)(2) excludes certain employee discounts from income as a tax-free fringe benefit.) He sold the desk in 2008 for \$14,000.

- (a) What is the tax consequence in 2008 when Bauer bought the desk?
- (b) How much gain does he realize in 2008 when he sells the desk?
- (c) How much was his economic gain?
- (d) How much gain was he taxed on?
- (e) If the answers to (c) and (d) are different, what accounts for the difference?

Solution to h/o 9, Problem 1

In 2004, Belcor bought a diamond necklace for \$1,000 and Filler bought a gold chain for \$500. On January 12, 2008, when each item was worth \$2,000, they contracted to exchange their necklace and chain with each other. By the time they exchanged the jewelry on November 1, 2008, Belcor's necklace was worth only \$1,800. Answer the following questions and try to prove the result.

<u>Belcor</u>		<u>Filler</u>	
FMV of necklace	\$ 1,800	FMV of gold chain	\$ 2,000
basis	1,000	basis	500

Answer the following questions and try to prove the result.

	<u>Answer</u>	<u>Calculation</u>
(a) What is Belcor's gain on the disposition of the necklace?	\$1,000	2,000 - 1,000
(b) What is Belcor's basis for the chain?	\$2,000	its FMV
(c) What is Filler's gain on the disposition of the chain?	\$1,300	1,800 - 500
(d) What is Filler's basis for the necklace?	\$1,800	its FMV
(e) If Belcor sells the chain for \$5,000, how much is the gain?	\$3,000	5,000 - 2,000
(f) If Filler sells the necklace for \$6,000, how much is the gain?	\$4,200	6,000 - 1,800

Proof of the Result

Belcor began with \$1,000 when she purchased the necklace and ended with \$5,000 when she sold the chain resulting in an economic gain of \$4,000. She was taxed on \$1,000 of gain in (a) when she exchanged the necklace and another \$3,000 of gain in (e) when she sold the chain, resulting in \$4,000 of gain for tax purposes.

If Belcor's basis in the chain in transaction (b) above had been \$1,800, the value she "paid," her gain in part (e) would have been \$3,200. She would have been taxed on \$4,200 of gain (\$3,200 in part (e) and \$1,000 in part (a)) although she had only \$4,000 of economic gain.

Filler began with \$500 when she purchased the chain and ended with \$6,000 when she sold the necklace, resulting in an economic gain of \$5,500. \$1,300 of gain was taxed when she exchanged the chain in (c) and \$4,200 of gain was taxed when she sold the necklace in (f), resulting in \$5,500 of gain for tax purposes.

The tax gain equaled the economic gain using the *Philadelphia Park* rule although the value of the two properties was not equal at the time of the exchange.

Solution to Problem 2, Casebook Page 79

	Transaction	cash investment	adjusted basis
a	bought a \$500,000 home, with \$100,000 cash and \$400,000 loan she invested \$100,000 of her own funds	100,000	500,000
b	paid \$100,000 of loan principal she invested an additional \$100,000 of her own funds to reduce the loan	100,000	500,000
c	refinanced the \$300,000 balance of the loan with a \$500,000 loan (1) \$50,000 of extra proceeds was used to remodel the home basis increased by amount used to improve the home \$50,000 came from bank, so she did not invest any more funds (2) \$100,000 of extra proceeds used to purchase land (3) \$50,000 of extra proceeds used for a vacation (she withdrew \$150,000 of loan proceeds for purposes unrelated to the home, which reduced her investment in the home by \$150,000.	(100,000) (50,000)	550,000
d	the balance of the \$500,000 loan at the time of sale was \$450,000 (she reduced the loan principal by paying \$50,000 from her funds)	50,000	
	balance of her cash investment in the home at this point	<u>100,000</u>	
	basis of home		550,000

She sold the home for \$750,000, receiving \$350,000 in cash; buyer assumed the \$450,000 loan.

Tax Gain on Home

amount realized	\$800,000
minus adjusted basis	- 550,000
equals gain on sale	<u>\$250,000</u>

Cash Profit on Home

cash received at sale		\$350,000
plus withdrawals for land and vacation		150,000
minus:		
down payment	- 100,000	
principal payments	- <u>150,000</u>	
	-250,000	<u>-250,000</u>
cash profit		<u>\$250,000</u>

Explanation of land and vacation purchases

She paid \$100,000 for the tract of land and spent \$50,000 on a vacation from the \$500,000 refinanced loan. If she had not made those expenditures, she would have borrowed only \$350,000 (\$300,000 to refinance the loan and \$50,000 to remodel the home). The loan balance at the time of sale would have been \$300,000 instead of \$450,000, so she would have received \$500,000 cash at the closing. The cash profit would have been calculated as follows:

cash received at closing		\$500,000
- \$100,000 down payment	100,000	
- principal payments	- <u>150,000</u>	<u>- 250,000</u>
cash profit		\$250,000

GIFT & ESTATE TAX OVERVIEW

The gift and estate tax is a separate tax system from the income tax. It taxes the donor on the value of gifts made during her life and taxes the estate on the value of property owned at death. Therefore, you should distinguish gifts for income tax purposes from gifts for gift tax purposes. You will not be responsible for the gift and estate tax, but there are several references to it in the income tax materials.

GIFT TAX (taxed to donor)

Annual Exclusion

A donor can make gifts of \$12,000 per year to as many donees as she wants. If donor is married, the exclusion is \$24,000 per donee per year, if donor's spouse consents.

Educational and Medical Exclusion

In addition to the annual exclusion, a donor may make an unlimited amount of gifts on behalf of a donee *directly* to an educational institution for tuition (not room or board) and amounts paid *directly* to health care providers for medical services on behalf of a donee.

Lifetime Exclusion: Every individual may make up to \$1 million of gifts during her life without gift tax consequences.

Tax Rate: The tax rate on all gifts is 45% in 2008-2009 and will be 35% in 2010 and thereafter.

Marital Deduction: all gifts to a spouse are excluded from the gift tax.

ESTATE TAX (taxed to estate)

Lifetime exclusion:

2008: \$2 million (reduced by any exclusion used for gift tax)
2009: \$3.5 million (reduced by any exclusion used for gift tax)
2010: unlimited
2011: \$600,000

Tax Rate: 45% in 2008-2009; zero 2010; 55% in 2010 and thereafter unless Congress acts.

Status of Estate Tax Repeal

The 2001 Tax Act repealed the estate tax (not the gift tax) in year 2010, but the Act expires in 2010. If Congress doesn't act, the estate tax is reinstated in 2011 as it was prior to the 2001 Act. The top tax rate will be 55% on estates over \$2.5 million and the lifetime exclusion will be only \$600,000. Several attempts by the House of Representatives to repeal the estate tax have failed. Educated guessers predict that the lifetime exclusion will be raised to about \$5 million and the tax rate will be lowered from the current 45% to about 35%.

INCOME TAX RATES on Estates and Trusts

up to \$2,150	15%
\$2,150 to \$5,000	25%
\$5,000 - \$7,650	28%
\$7,650 - \$10,450	33%
over \$10,450	35%

PATRON SERVES BARTENDER \$10,000

By Jason Probst The Hutchinson (Kansas) News, August 31, 2006

A tip calculator figures that \$3.90 is an acceptable tip for a \$26 meal - a 15 percent nod to a waiter or bartender for a job well done. Generous tippers might leave \$5.20, or 20 percent of the bill, as a bigger token of appreciation for caring for a customer's needs. But it's difficult to find a word that adequately describes the customer who signs off on a \$26 dinner bill and puts down \$10,000 for the tip. Never happen? It did - a 38,461 percent tip - right here in Hutchinson. Cindy Kienow, a bartender at Applebee's Bar and Grill, received a \$10,000 tip last Sunday after a customer signed the bill for his \$26 meal. "He usually signs his ticket and flips it upside down," Kienow said. "But this time, he had it right side up and said 'I want you to know this is not a joke.' "

Kienow, who has worked at Applebee's for eight years, said the man is a regular customer who comes in a couple of times each month and sits at the end of the bar to eat his meal. He usually orders two beers, cheese quesadillas for an appetizer and an entrée for dinner, and he always tips very well, Kienow said - generally leaving a \$15 tip on a \$30 ticket.

Two weeks ago, the same customer left her a \$100 tip, but the size of Sunday's tip left her in shock. "I couldn't move," Kienow said. "I didn't know what to say. He said, 'This will buy you something kind of nice, huh,' and I said, 'Yeah, it will.' "

Rhodri McNee, vice president of operations for JS Enterprises, the owner of the Hutchinson Applebee's, said the company is in the final stages of verifying the tip. "This is a great deal for us and a great deal for Cindy," McNee said. "We did have a guest leave this tip on a credit card, and we're doing everything to make sure it's a valid charge."

McNee said the company is exercising caution to protect the customer's privacy and ensure that the tip goes through the appropriate channels to end up in Kienow's hands. "Nothing would make us happier than to present her with that check," McNee said. "She's been with us for eight years, and she's a great employee who does a great job."

Kienow isn't sure what she did to deserve the tip, but she said she feels honored and privileged that the man thought her efforts were worth that much money. "It's a great compliment," Kienow said. "I'm still kind of in shock." She talked with the customer, described as a man in his mid-40s, every time he came into the restaurant. He lives in the area, Kienow said, but she didn't learn many details about the man's personal life.

Mostly, they talked about the weather, current events or recent happenings - the sort of talk that's common between a bartender and a patron. But there's not a specific incident she can think of that prompted the extra large tip. "I've been waiting on him for about three years," Kienow said. "We'd just talk across the bar - he's a really nice guy. ... I hope he comes back in so I can tell him thank you, because the other day I was kind of dumb-founded."

The 35-year-old Kienow said she's not entirely sure what she'd like to do with the money. Her dad is scheduled for double-knee surgery and will have to take some time off work. "I'd like to take care of my parents, since they always took care of me," Kienow said. "But I feel like he wanted me to buy something for myself, and there's a Jeep that I've had my eye on for a while."

CHAPTER 5 PROBLEMS

1. Read h/o 13 and advise Cindy how she should treat the tip for income tax purposes.
2. Weiss gave Brandenburg CBS stock that cost \$20,000 and was worth \$30,000 at the time of the gift. What is Brandenburg's gain or loss if he sells the stock for the following amounts?
 - (a) \$35,000
 - (b) \$15,000
 - (c) \$25,000
3. Wretzky gave Bauer GE stock that cost \$52,000 and was worth \$30,000 at the time of the gift. What is Bauer's gain or loss if he sells the stock for the following amounts?
 - (a) \$60,000
 - (b) \$18,000
 - (c) \$47,000
4. Blackney purchased GM stock for \$32,000 and gave it to Springfield when it was worth \$22,000. What is Springfield's gain or loss if he sells the stock for the following amounts?
 - (a) \$21,000
 - (b) \$30,000
 - (c) \$40,000
5. Deconinck paid \$40,000 for Abbott Labs stock and gave it to Rice when it was worth \$50,000. What is Rice's gain or loss if she sells the stock for the following amounts?
 - (a) \$45,000
 - (b) \$55,000
 - (c) \$35,000

5. Jim purchased AOL stock in 2001 for \$30,000 and gave it to his elderly father on June 12, 2008 when it was worth \$100,000. His father died on September 19, 2008 when the stock was worth \$110,000. Jim inherited the stock and sold it on September 22, 2008 for \$115,000.
- (a) What is Jim's gain or loss on the sale? Read the first paragraph on casebook 103 and § 1014(e)(1).
 - (b) What is Jim's gain or loss on the sale if his dad died August 12, 2007 when the stock was worth \$110,000 and Jim sold the stock on September 21, 2008 for \$115,000?
6. Joyce purchased property for \$10,000 and sold it to her daughter Bonnie for \$21,000 when the FMV was \$50,000.
- (a) What are the tax consequences to Joyce and Bonnie at the time of the transaction? See Reg. §1.1001-1(e).
 - (b) What is Bonnie's gain or loss if she sells the property for \$5,000? See Reg. § 1.1015-4(a)(1).
 - (c) How much total economic gain did mom and daughter realize?
 - (d) How much total income did they have to pay tax on?
7. Same as problem 6, except Joyce bought the stock for \$30,000.

CHANGE IN SALE OF RESIDENCE EXCLUSION RULES

The President signed the Mortgage Forgiveness Debt Relief Act of 2007 (H.R. 3648) on December 20, 2007. The Act excludes from gross income amounts attributable to a discharge of mortgage debt incurred to acquire a principal residence. (We will study discharge of debt income in Chapter 9.) The Act added the following new subsection (4) to § 121(b) which becomes effective on

(4) (a) In General- Subsection (b) of section 121 of the Internal Revenue Code of 1986 (relating to limitations) is amended by adding at the end the following new paragraph:

(A) IN GENERAL- Subsection (a) shall not apply to so much of the gain from the sale or exchange of property as is allocated to periods of nonqualified use.

(B) GAIN ALLOCATED TO PERIODS OF NONQUALIFIED USE- For purposes of subparagraph (A), gain shall be allocated to periods of nonqualified use based on the ratio which--

(i) the aggregate periods of nonqualified use during the period such property was owned by the taxpayer, bears to (ii) the period such property was owned by the taxpayer. * * *

(C) PERIOD OF NONQUALIFIED USE- For purposes of this paragraph--

(i) IN GENERAL- The term 'period of nonqualified use' means any period (other than the portion of any period preceding January 1, 2008) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.

The following examples will illustrate the effect of the change.

Example 1

Jason buys a property for \$400,000 on January 1, 2008 and rents it for two years, deducting \$20,000 of depreciation. On January 1, 2010, he begins using it as his principal residence. On January 1, 2013, Jason moves out and sells the property for \$800,000, realizing a gain of \$420,000.

\$20,000 of gain attributable to depreciation is not excluded from income (see the second full paragraph on 126). Under prior law, Jason could exclude \$250,000 of the \$400,000 remaining gain and report \$150,000 of long-term capital gain.

Section 121(b)(4) now requires him to allocate the exclusion. He used the home as his principal residence for three of the five years prior to the sale, so he is entitled to only 60% of the exclusion (3 years of qualified use ÷ 5 years of ownership). \$250,000 exclusion x 60% equals \$150,000 of exclusion available. \$150,000 of the \$400,000 remaining gain is excluded and the \$250,000 balance is taxed as long-term capital gain.

Example 2

Same facts except Jason sold the home on January 1, 2012 after using it as a residence for two years. During his four years of ownership, he used it only one-half of the time for qualified use, so he is entitled to only 50% of the \$250,000 exclusion. After including \$20,000 of income attributable to depreciation, only \$125,000 of the remaining \$400,000 of gain is excluded. The \$275,000 balance is taxed as long-term capital gain.

SALE OF RESIDENCE PROBLEMS

Determine how much gain the taxpayers may exclude under § 121 in the following problems. Married couples will file a joint return and the entire profit is reported on their return. Single taxpayers report their respective share of the profit on their separate tax returns.

Problem 1

1/5/02 Wanda bought a home for \$200,000
1/1/05 Barry moved in
8/1/05 they married
7/1/06 they moved and sold the home for \$800,000

Problem 2

1/5/02 Brenda bought a home for \$200,000
1/1/05 Larry moved in
8/1/05 they married
7/1/06 they moved because of Larry's change of employment and sold the home for \$800,000
7/1/06 they purchased a new home for \$950,000

Problem 3

1/5/02 Linda bought a home for \$200,000
1/1/05 Gary moved in
8/1/05 they married
7/1/06 they moved because of Linda's change of employment and sold the home for \$800,000
7/1/06 they purchased a new home for \$950,000

Problem 4

1/5/02 Deborah bought a home for \$200,000
1/1/05 Jerry moved in
7/1/05 Deborah transferred a one-half interest in joint tenancy to Jerry
7/1/06 They sold the home for \$800,000.

Problem 5

Same facts as problem 4, but they sold the home for \$500,000.

Problem 6

Same facts as problem 5, but they were married at the time of the sale.

Problem 7

1/5/02 Sally bought a home for \$200,000
1/1/05 Harry moved in
7/1/05 Sally transferred to Harry a one-half interest in joint tenancy
7/1/06 they moved because of Harry's change of employment and sold the home for \$800,000

EMPLOYER-PROVIDED EDUCATIONAL BENEFIT EXCLUSIONS

Qualified Tuition Reduction § 117(d)

Most universities have tuition reduction plans that enable employees, their spouses and dependents to attend classes tuition-free. Section 117(d) excludes the value of tuition for undergraduate courses.

Educational Assistance Programs § 127

When an employer reimburses an employee for tuition, the reimbursement is additional compensation to the employee unless a Code section excludes it. Section 127 excludes up to \$5,250 of tuition reimbursements received from an employer for both undergraduate and graduate courses. The exclusion applies whether or not the education is related to the employee's work.

Example 1

Prof. Brill's son attends Chicago-Kent tuition-free and Brill must include the value of the tuition in his income. Section 117(d) does not apply because the courses are graduate courses. Section 127 does not apply because that section excludes \$5,250 of tuition for an employee, not the spouse or dependents of the employee.

Working Condition Fringe Benefits § 132(d)

Code § 132(d) excludes some tuition reimbursements as "working condition" fringe benefits. (We will study fringe benefit exclusions in Chapter 11.) Working condition fringe benefits are amounts the employer reimburses the employee for that the employee could have deducted as a business expense under § 162 if she had paid them herself. A taxpayer may deduct the cost of tuition as a business expense if the education maintains or improves skills in her employment. However, if the education prepares the taxpayer for a new trade or profession, the expense is not deductible.

Example 2

First Bank reimbursed Rosen, a manager in the finance department, for \$9,000 of tuition he paid for a graduate course in finance, which improves her skills. If her employer had not reimbursed her, she could have deducted the tuition as a business expense under § 162. Therefore she may exclude the reimbursement under § 132(d).

If the reimbursement had been for law school tuition, she could not have deducted the expense because it prepares her for a new profession. Therefore she cannot exclude the \$9,000 reimbursement as a § 132(d) working condition fringe benefit, but she may exclude \$5,250 of the reimbursement under § 127.

Example 3

Prof. Rudstein took a graduate course in the law school's LL.M. tax program that would normally cost \$10,000. He did not pay tuition because of the university's tuition reduction plan. Rudstein may not exclude the \$10,000 under § 117(d) because it was a graduate course. You will learn that a lawyer may deduct the cost of graduate law courses because they maintain or improve her skills and a graduate law degree does not prepare a lawyer for a new profession. Rudstein could have deducted the tuition as a business expense if he had paid it himself, so he may exclude the full \$10,000 under § 132(d) as a working condition fringe benefit.

EXCLUSION PROBLEMS

- (1) Microsoft reimbursed employee Grosch \$10,000 for law school tuition. She is a computer programmer and Microsoft is paying her law school tuition so she can program legal software. How much of the \$10,000 reimbursement may she exclude under §§ 117(d), 127 or 132(d)?
- (2) What if the company paid \$10,000 of tuition for her to obtain a master's degree in archeology that has nothing to do with her work at Microsoft?
- (3) How much income should Professor Spak report in the following situations? He and his sons take the courses at IIT and Spak does not pay tuition pursuant to the university's tuition reduction plan.
 - (a) His younger son is an undergraduate majoring in chemical engineering.
 - (b) His older son attends Chicago-Kent.
 - (c) Spak takes courses in the graduate tax program.
 - (d) Spak takes undergraduate psychology courses.
 - (e) Spak takes graduate psychology courses.
- (4) Sue, an Evening division student at Kent, works full-time as a faculty secretary. As an employee, she receives nine hours of law school credit without charge. How should she report this on her income tax return?
- (5) A Chicago-Kent student receives two free hours of tuition for serving as a TA. Is this taxable income? (Assume the value of the tuition was subtracted from the tuition bill instead of being paid in cash.) See § 117(d)(5), but read § 117(c)(1) carefully.

LIFE INSURANCE PRORATED AMOUNT

Section 101(d), discussed at the bottom of casebook 150 and the top of 151, explains how insurance proceeds received over a period of time are taxed. To compute the § 101(d)(1) “prorated” amount excluded from the beneficiary’s income, divide the face amount of the policy by the number of periods the payments will be made. The face amount is the death benefit. The number of periods is either a fixed number of years or the life expectancy of the beneficiary, depending on the insurance contract. The result is the amount of each annual payment excluded; the balance of each payment is included as interest income.

Example

Able purchased a \$100,000 term policy on his life and paid the first \$100 premium. He died in a car accident the next week and his widow Barbara elected to receive the \$100,000 over her life expectancy of 25 years. The insurance company contracted to pay her \$6,000 per year for her life. The amount excluded is computed as follows:
 $\$100,000 \text{ face amount} \div 25 \text{ year life expectancy} = \$4,000 \text{ excluded each year}$

The \$4,000 exclusion continues as long as the beneficiary lives, even if the beneficiary lives beyond her life expectancy. If Barbara lives more than 25 years and receives \$6,000 in the 26th year, she will still exclude \$4,000 although she has recovered the entire \$100,000 face value of the policy tax free. (She excluded \$4,000 per year for 25 years.)

If the beneficiary dies before recovering the face amount of the policy, there is no deduction for the unrecovered portion of the face amount. If Barbara died two years after her husband, she will have received \$12,000 and excluded only \$8,000. The \$88,000 balance of the insurance is lost, but her estate does not get any tax deduction for amount that ended at her death

PROBLEMS

Bill was the beneficiary of his wife’s \$75,000 life insurance policy; she paid \$12,000 of premiums before her death. What are the tax consequences to Bill if elects the following settlement options?

- (1) He takes the \$75,000 in a lump sum payment.
- (2) The insurance company will retain the \$75,000 and pay him 6% interest per year, § 101(c).
- (3) He elected to receive \$7,500 per year for his 12-year life expectancy. What are the tax consequences:
 - (a) when he receives the first \$7,500 payment?
 - (b) when he receives the \$7,500 payment 14 years after his wife’s death?
 - (c) if he dies two years after the payments began and the balance of the insurance proceeds are lost?

CANCELLATION OF DEBT

Code § 61(a)(12) provides that when a creditor forgives or cancels part of a debt, the amount forgiven is income from the discharge of indebtedness. This is referred to as cancellation of debt (“COD”) income. For example, Wetzel lent Solberg \$10,000 three years ago and Wetzel now agrees to accept \$7,000 in full payment of the debt. Solberg paid the \$7,000 and Wetzel cancelled the \$3,000 balance. Solberg must report \$3,000 of COD income, unless excluded by a Code provision or common law.

Balance Sheets

Assets are the cash and property an entity owns and liabilities are what an entity owes to creditors. Assets minus liabilities equals net worth ($A - L = NW$). Net worth is the amount of assets remaining for the owner after liabilities are subtracted.

Example 1

Adam has \$5,000 of cash and owes Visa \$2,000. His net worth is \$3,000 (\$5,000 assets - \$2,000 liabilities). Adam's balance sheet would look like this:

<u>Adam's Balance Sheet</u>			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$5,000	Visa payable	\$2,000
		<u>Net Worth</u>	<u>\$3,000</u>
Total Assets	<u>\$5,000</u>	Liabilities & Net Worth	<u>\$5,000</u>

Assets are listed on the left side of the balance sheet. The claims on the assets are listed on the right side. The creditors have a \$2,000 claim on the assets and the \$3,000 balance of the assets belong to Adam. He is solvent by \$3,000.

Example 2

Betty has \$10,000 of cash and owes \$16,000 in student loans. Her balance sheet looks like this:

<u>Betty's Balance Sheet</u>			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$10,000	Student loans	\$16,000
		<u>Net Worth</u>	<u>(6,000)</u>
Total Assets	<u>\$10,000</u>	Liabilities & Net Worth	<u>\$10,000</u>

Her liabilities exceed her assets by \$6,000 so Betty has a negative net worth of \$6,000. She is *insolvent* by \$6,000 (see § 108(d)(3)).

Cancellation of Debt When Debtor is Insolvent

There are several statutory and common law exclusions of gross income, one of which is the insolvency exception. Code § 108(a)(1)(B) provides that COD income is excluded if the debtor is insolvent after the debt is cancelled.

Example 3

Charlene has \$14,000 of cash and owes VISA \$5,000 and American Express \$15,000. Her \$20,000 of liabilities exceed the \$14,000 of assets, giving her a negative net worth of \$6,000. She is insolvent by \$6,000. Her balance sheet looks like this:

<u>Charlene's Balance Sheet</u>			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$14,000	VISA	\$ 5,000
		American Express	<u>15,000</u>
		Total Liabilities	20,000
		<u>Net Worth</u>	<u>(6,000)</u>
Total Assets	<u>\$14,000</u>	Liabilities & net worth	<u>\$14,000</u>

VISA agrees to accept \$4,000 in full payment of the \$5,000 debt. Visa cancelled \$1,000 of her debt, which is COD income unless excluded by the Code. After she pays Visa, her balance looks like this:

<u>Charlene's Balance Sheet</u>			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$10,000	American Express	15,000
		<u>Net Worth</u>	<u>(5,000)</u>
Total Assets	<u>\$10,000</u>	Liabilities & Net Worth	<u>\$10,000</u>

After the transaction she is still insolvent. Code § 108(a)(1)(B) excludes the \$1,000 cancellation.

American Express now agrees to accept \$9,000 in full payment of their \$15,000 debt and forgive \$6,000. Charlene's balance sheet after the American Express transaction looks like this:

<u>Charlene's Balance Sheet</u>			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$1,000		0
		<u>Net Worth</u>	<u>\$1,000</u>
Total Assets	<u>\$1,000</u>	Liabilities & Net Worth	<u>\$1,000</u>

After the transaction she is solvent by \$1,000. Code § 108(a)(3) provides that the exclusion cannot exceed the amount by which the taxpayer is insolvent. Before the American Express payment she was insolvent by \$5,000. American Express forgave \$6,000 of the debt, but only \$5,000 is excluded. The \$1,000 balance, the amount by which she is solvent after the transaction, is included in gross income.

CANCELLATION OF MORTGAGE DEBT

Individuals who lost their homes due to foreclosure, or have refinanced their mortgages to prevent foreclosure, faced cancellation of debt income to the extent their lenders forgave part of the debt. When a family is under financial stress, the last thing they need is a higher tax bill. To prevent this situation, Congress passed the Mortgage Forgiveness Debt Relief Act of 2007 in December 2007. This legislation excludes income from canceled mortgage debt for three years, retroactive to the beginning of 2007. Only "qualified mortgage debt" is excluded, which is mortgage debt incurred to build, build, or substantially improve a taxpayer's principal residence (acquisition debt). Home equity debt and debt on second homes do not qualify. The maximum exclusion is \$2 million.

Mortgage Forgiveness Debt Relief Act of 2007

(a) In General- Paragraph (1) of section 108(a) of the Internal Revenue Code of 1986 is amended by striking 'or' at the end of subparagraph (C), by striking the period at the end of subparagraph (D) and inserting ', or', and by inserting after subparagraph (D) the following new subparagraph:

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2010.'.

(b) Special Rules Relating to Qualified Principal Residence Indebtedness- Section 108 of such Code is amended by adding at the end the following new subsection:

(h) Special Rules Relating to Qualified Principal Residence Indebtedness-

`(1) BASIS REDUCTION- The amount excluded from gross income by reason of subsection (a)(1)(E) shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer.

`(2) QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS- For purposes of this section, the term 'qualified principal residence indebtedness' means acquisition indebtedness (within the meaning of section 163(h)(3)(B), applied by substituting '\$2,000,000 (\$1,000,000' for '\$1,000,000 (\$500,000' in clause (ii) thereof) with respect to the principal residence of the taxpayer.

(3) EXCEPTION FOR CERTAIN DISCHARGES NOT RELATED TO TAXPAYER'S FINANCIAL CONDITION- Subsection (a)(1)(E) shall not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer. * * *

(5) PRINCIPAL RESIDENCE- For purposes of this subsection, the term 'principal residence' has the same meaning as when used in section 121.'.

(c) Coordination- * * *

(2) Paragraph (2) of section 108(a) of such Code is amended by adding at the end the following new subparagraph:

`(C) PRINCIPAL RESIDENCE EXCLUSION TAKES PRECEDENCE OVER INSOLVENCY EXCLUSION UNLESS ELECTED OTHERWISE- Paragraph (1)(B) shall not apply to a discharge to which paragraph (1)(E) applies unless the taxpayer elects to apply paragraph (1)(B) in lieu of paragraph (1)(E).'.

* * *

(d) Effective Date- The amendments made by this section shall apply to discharges of indebtedness on or after January 1, 2007.

COD PROBLEMS

1. Holland borrowed \$5,000 from Last National Bank. The loan is due but he does not have the money to repay it. What are the tax consequences if the bank agrees to accept \$2,000 and cancels the \$3,000 balance? See § 61(a)(12).
2. Eyber owes Walmart \$7,000. What are the tax consequences if the entire debt is cancelled in a title 11 bankruptcy case? See § 108(a)(1)(A).
3. (a) Wallen has \$20,000 of assets and \$30,000 of liabilities, including \$9,000 he owes to Smythe. What are the tax consequences if Smythe agrees to accept \$2,000 and cancels the \$7,000 balance of the loan? See § 108(a)(1)(B).
(b) Same facts as (a) but Wallen's liabilities are \$25,000 before Smythe cancelled \$7,000 of the loan. See §§ 108(a)(1)(B) and 108(a)(3).
4. Liebl borrowed \$20,000 from his parents to pay tuition. What is the result if his parents cancel the loan on graduation day? See § 102(a).
5. Grandma lent Neff \$10,000 to buy a new car. Grandma forgave the \$10,000 debt in her will, noting it was in appreciation of the care that Neff provided to her during the last years of her life. What are the tax consequences of the debt forgiveness?
6. Baker's bakery faltered and the employees agreed to accept \$3,000 in full settlement of the \$5,000 of wages owed them. How should she treat this for tax purposes? See § 108(e)(2).
7. Rippe had his car's transmission repaired at the Double A Transmission Shop and was outraged when he received the \$2,500 bill. What are the tax consequences to him if the owner agrees to accept \$1,500 in full payment of the bill?
(a) Does § 108(e)(5) permit him to exclude the \$1,000? Read § 108(e)(5)(A) carefully.
(b) Read the first paragraph under Disputed or Contested Debts on casebook p. 170 and see if that helps Rippe's case.
8. Montgomery contracted to purchase a condominium from Henderson for \$80,000, with payments to be made over a ten-year period. A few years later, when the loan balance was \$65,000, the FMV of the condo had declined to \$50,000 because of a downturn in the real estate market. Montgomery was insolvent. To prevent Montgomery from defaulting on the contract, Henderson agreed to reduce the balance owing on the loan to \$50,000. What are the tax consequences, if any, to Montgomery? What will be the basis in the condo after the debt reduction? See § 108(e)(5).
9. McCarthy owes Jackson \$12,000. Jackson agrees to accept \$9,000 in full payment. What are the tax consequences to McCarthy if she pays the \$9,000 with:
(a) \$9,000 in cash?
(b) a painting with a basis and a fair market value of \$9,000?
(c) a painting with a basis of \$5,000 and a fair market value of \$9,000?
(d) services worth \$9,000 by remodeling Jackson's garage?

DEDUCTION OF ATTORNEY'S FEES IN PERSONAL INJURY CASES

Code § 212(1) permits the deduction of attorneys' fees paid for personal injury awards only if the award is included in gross income. A \$300,000 judgment for a personal physical injury is excluded from income, so the plaintiff may not deduct the \$100,000 fee paid to her attorney. If \$60,000 of the award had been for punitive damages, it would have been included in her income. Because 20% of the award is included in her income, the plaintiff may deduct 20% of the \$100,000 attorney's fee under § 212(1), which we will study later.

The Code classifies expenses deducted under § 212, such as attorneys' fees, as 2% miscellaneous itemized deductions (2% MIDs), which we will also study later. 2% MIDs are only deductible to the extent they exceed 2% of AGI.

The Alternative Minimum Tax (AMT)

As we will study later, taxpayers must compute the tax the "regular" way, then compute it using the AMT rules and pay whichever tax is higher. Certain itemized deductions, including 2% MIDs, are not deductible for AMT purposes. If the taxpayer is subject to the AMT, the attorney's fee paid for nonphysical injuries and punitive damages are not deductible. As a result, the amount received for nonphysical injuries and punitive damages are included in gross income, but the attorney's fees are not deductible for AMT purposes.

Discrimination Cases

Code § 62 specifies which deductions are deductible as adjustments, rather than itemized deductions. As mentioned above, attorneys' fees in personal injury cases are classified as 2% miscellaneous itemized deductions and are not deductible for AMT purposes. Code § 62(a)(20) has classified attorney's fees paid in unlawful discrimination cases as adjustments, which are fully deductible for AMT purposes. Section 62(e) defines "unlawful discrimination."

For example, Lydia, who will be subject to the AMT in 2008, received a \$200,000 settlement for age discrimination. The full amount is included in her gross income. She paid her attorney \$50,000 and can deduct the full amount as an adjustment (see § 62(e)(5)) under the AMT. The net result is that Lydia will pay tax on only the \$150,000 net amount she received.

ADDITIONAL INFORMATION FOR CHAPTER 10 PROBLEMS

Problem 3

Consider the first 19 lines of the problem, through “What advice would you give?” For this part of the question, determine what damages are excluded and how she should deduct the attorney’s fee. Study the last two sentences of § 104(a) immediately before § 104(b).

For the next part of the problem involving the unwanted physical contact and bruising, do the additional facts make it an excludible physical injury? See PLR 200041, discussed near the bottom of 189, and *Amos* following this handout page. Assuming there is a physical injury, can Mary establish that the damages were awarded “on account of” and were intended to compensate for that physical injury, as required by *Schleier*, discussed on 188?

For Problem 4, consider the following questions:

1. How Susan should treat the amounts received from her own policy? See § 104(a)(3).
2. How should she treat the amounts she received from her employer’s policy? See §§ 104(a)(3), 105(a) and 105(b).
3. How should Susan treat the health insurance premiums that her employer paid? See § 106.

AMOS v. COMMISSIONER
T.C. Memo 2003-329 (2003)

CHIECHI, Judge:

The only issue remaining for decision n1 is whether the \$ 200,000 settlement amount that petitioner received in 1997 in settlement of a claim is excludable under section 104(a)(2) from petitioner's gross income for that year. We hold that \$ 120,000 is excludable and that \$ 80,000 is not.

FINDINGS OF FACT

Most of the facts have been stipulated and are so found. At the time petitioner filed the petition in this case, he resided in Minneapolis, Minnesota.

During 1997, petitioner was employed as a television cameraman. In that capacity, on January 15, 1997, petitioner was operating a handheld camera during a basketball game between the Minnesota Timberwolves and the Chicago Bulls. At some point during that game, Dennis Keith Rodman (Mr. Rodman), who was playing for the Chicago Bulls, landed on a group of photographers, including petitioner, and twisted his ankle. Mr. Rodman then kicked petitioner. (We shall refer to the foregoing incident involving Mr. Rodman and petitioner as the incident.)

On January 15, 1997, shortly after the incident, petitioner was taken by ambulance for treatment at Hennepin County Medical Center. Petitioner informed the medical personnel at that medical center (Hennepin County medical personnel) that he had experienced shooting pain to his neck immediately after having been kicked in the groin, but that such pain was subsiding. The Hennepin County medical personnel observed that petitioner was able to walk, but that he was limping and complained of experiencing pain. The Hennepin County medical personnel did not observe any other obvious signs of trauma. * * *

While petitioner was seeking treatment at Hennepin County Medical Center, he contacted Gale Pearson (Ms. Pearson) about representing him with respect to the incident. Ms. Pearson was an attorney who had experience in representing plaintiffs in personal injury lawsuits. After subsequent conversations and a meeting with petitioner, Ms. Pearson agreed to represent him with respect to the incident.

On January 15, 1997, after the incident and

petitioner's visit to the Hennepin County Medical Center, petitioner filed a report (police report) with the Minneapolis Police Department. In the police report, petitioner claimed that Mr. Rodman had assaulted him.

On January 16, 1997, petitioner sought medical treatment at the Veterans Affairs (VA) Medical Center. The medical personnel at that medical center (VA medical personnel) took X-rays of petitioner's back. Petitioner complained to the VA medical personnel about his groin area, but he did not advise them that he was experiencing any symptoms related to that complaint. The VA medical personnel determined that there was no swelling of, but they were unable to ascertain whether there was bruising around, petitioner's groin area. The VA medical personnel gave petitioner some pain medication and told him to continue taking his other prescribed medications.

* * *

Very shortly after the incident on a date not disclosed by the record, Andrew Luger (Mr. Luger), an attorney representing Mr. Rodman with respect to the incident, contacted Ms. Pearson. Several discussions and a few meetings took place between Ms. Pearson and Mr. Luger. Petitioner accompanied Ms. Pearson to one of the meetings between her and Mr. Luger, at which time Mr. Luger noticed that petitioner was limping. Shortly after those discussions and meetings, petitioner and Mr. Rodman reached a settlement.

On January 21, 1997, Mr. Rodman and petitioner executed a document entitled "CONFIDENTIAL SETTLEMENT AGREEMENT AND RELEASE" (settlement agreement).

[The settlement agreement provided that Rodman would pay Amos \$200,000, without allocation, that the settlement covered not only any physical injuries to Amos, but also Amos' agreement not to defame Rodman; not to disclose the existence or terms of the agreement; not to publicize the incident; and not to assist in any criminal prosecution against Rodman with respect to the matter (Amos had filed a police report, claiming Rodman had assaulted him, on the day of the incident). The agreement also provided that Rodman did not admit any liability for the incident.]

Petitioner filed a tax return (return) for his taxable year 1997. In that return, petitioner excluded from his gross income the \$ 200,000 that he received from Mr. Rodman under the settlement agreement. In the notice that respondent issued to petitioner with respect to 1997, respondent determined that petitioner is not entitled to exclude the settlement amount from his gross income.

OPINION

We must determine whether the settlement amount at issue may be excluded from petitioner's gross income for 1997.

Section 61(a) provides the following sweeping definition of the term "gross income": "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived".

Section 104(a)(2) on which petitioner relies provides that gross income does not include:

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness; * * *

Where damages are received pursuant to a settlement agreement, such as is the case here, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under section 104(a)(2). *United States v. Burke*, supra at 237. The determination of the nature of the claim is factual. Where there is a settlement agreement, that determination is usually made by reference to it. If the settlement agreement lacks express language stating what the amount paid pursuant to that agreement was to settle, the intent of the payor is critical to that determination. Although the belief of the payee is relevant to that inquiry, the character of the settlement payment hinges ultimately on the dominant reason of the payor in making the payment. Whether the settlement payment is excludable from gross income under section 104(a)(2) depends on the nature and character of the claim asserted, and not upon the validity of that claim.

The dispute between the parties in the instant case relates to how much of the settlement amount at issue Mr. Rodman paid to petitioner on account of physical injuries. It is petitioner's position that the entire \$ 200,000 settlement amount at issue is excludable from his gross income under section

104(a)(2). In support of that position, petitioner contends that Mr. Rodman paid him the entire amount on account of the physical injuries that he claimed he sustained as a result of the incident.

Respondent counters that, except for a nominal amount (i.e., \$ 1), the settlement amount at issue is includable in petitioner's gross income. In support of that position, respondent contends that petitioner has failed to introduce any evidence regarding, and that Mr. Rodman was skeptical about, the extent of petitioner's physical injuries as a result of the incident. Consequently, according to respondent, the Court should infer that petitioner's physical injuries were minimal. * * *

On the instant record, we reject respondent's position. With respect to respondent's contentions that petitioner has failed to introduce evidence regarding, and that Mr. Rodman was skeptical about, the extent of petitioner's physical injuries as a result of the incident, those contentions appear to ignore the well-established principle under section 104(a)(2) that it is the nature and character of the claim settled, and not its validity, that determines whether the settlement payment is excludable from gross income under section 104(a)(2). In any event, we find below that the record establishes that Mr. Rodman's dominant reason in paying the settlement amount at issue was petitioner's claimed physical injuries as a result of the incident. * * *

Our finding is supported by the settlement agreement, a declaration by Mr. Rodman (Mr. Rodman's declaration), n6 and Ms. Pearson's testimony.

n6 The parties introduced into evidence a declaration by Mr. Rodman, who did not appear as a witness at trial. The parties stipulated the accuracy and truthfulness of Mr. Rodman's statements in that declaration.

The settlement agreement expressly provided that Mr. Rodman's payment of the settlement amount at issue releases and forever discharges * * * [Mr.] Rodman * * * from any and all claims and causes of action of any type, known and unknown, upon and by reason of any damage, loss or injury * * * sustained by Amos [petitioner] arising, or which could have arisen, out of or in connection with * * * [the incident].

Mr. Rodman stated in his declaration that he entered into the settlement agreement "to resolve any potential claims" and that the settlement

agreement was intended to resolve petitioner's "claim without having to expend additional defense costs." The only potential claims of petitioner that are disclosed by the record are the potential claims that petitioner had for the physical injuries that he claimed he sustained as a result of the incident. Furthermore, Ms. Pearson testified that Mr. Rodman paid the entire settlement amount at issue to petitioner on account of his physical injuries. As discussed below, Ms. Pearson's testimony that Mr. Rodman paid that entire amount on account of petitioner's physical injuries is belied by the terms of the settlement agreement. Nonetheless, her testimony supports our finding that Mr. Rodman's dominant reason in paying petitioner the settlement amount at issue was to compensate him for claimed physical injuries relating to the incident.

We have found that Mr. Rodman's dominant reason in paying petitioner the settlement amount at issue was to compensate him for his claimed physical injuries relating to the incident. However, the settlement agreement expressly provided that Mr. Rodman paid petitioner a portion of the settlement amount at issue in return for petitioner's agreement not to: (1) Defame Mr. Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Mr. Rodman with respect to the incident (collectively, the nonphysical injury provisions).

The settlement agreement does not specify the portion of the settlement amount at issue that Mr. Rodman paid petitioner on account of his claimed physical injuries and the portion of such amount that Mr. Rodman paid petitioner on account of the nonphysical injury provisions in the settlement agreement. Nonetheless, based upon our review of the entire record before us, and bearing in mind that petitioner has the burden of proving the amount of the settlement amount at issue that Mr. Rodman paid him on account of physical injuries, we find that Mr. Rodman paid petitioner \$ 120,000 of the settlement amount at issue on account of petitioner's claimed physical injuries and \$ 80,000 of that amount on account of the nonphysical injury provisions in the settlement agreement. On that record, we further find that for the year at issue petitioner is entitled under section 104(a)(2) to exclude from his gross income \$ 120,000 of the settlement amount at issue and is required under section 61(a) to include in his gross income \$ 80,000 of that amount.

We have considered all of the contentions and arguments of respondent and of petitioner that are not discussed herein, and we find them to be without merit, irrelevant, and/or moot.

To reflect the foregoing and the concessions of the parties, Decision will be entered under Rule 155.

FLEXIBLE SPENDING ARRANGEMENTS (FSAs)

Medical Care Reimbursement Plans §125

Medical expenses are deductible only to the extent they exceed 7½% of AGI. A taxpayer with AGI of \$50,000 cannot deduct the first \$3,750 of medical expenses. The 7½% floor prevents most taxpayers from deducting medical expenses, unless they have large uninsured expenses. However, if an employer offers a medical reimbursement plan (a flexible spending plan), an employee can obtain a tax advantage from the expenditures. The plan works as follows. An employee elects to have a specified amount of salary contributed to the plan and Code § 125 excludes the designated amount from the employee's income. The employer determines the maximum an employee can contribute to the plan; there is no statutory maximum. (IIT limits the contribution to \$4,000 per year.)

Prof. Jones, an IIT employee, designates \$4,000 for the medical FSA plan. IIT withholds \$333 from her pay each month ($\$4,000 \div 12$ months) and credits it to her plan account. \$4,000 is excluded from her income, saving her \$1,000 of tax if she is in the 25% bracket. Jones submits receipts for medical expenses and IIT reimburses her up to \$4,000.

The employer must reimburse the full amount submitted for reimbursement (up to the amount the employee designated), regardless of the amount the employee has contributed. For example, if Jones seeks reimbursement for a \$2,000 uninsured dental expense in the first month of the plan, IIT will reimburse the \$2,000 although she has only contributed \$333 to the plan thus far. If Jones leaves IIT the next month, the university loses \$1,667 and cannot seek reimbursement from Jones. This is the employer's risk.

On the other hand, if Jones does not spend the full \$4,000 during the year, she will forfeit the balance remaining in the plan. The employer retains the amounts forfeited, which help offset losses described in the previous paragraph. Employees must designate the amount of the contribution before the plan year begins, so they must accurately estimate their medical expenses for the plan year to avoid forfeiting unspent contributions. Employers can permit employees to use expenses incurred up to 2½ months after the end of the plan year to qualify for reimbursement from the plan, which reduces the risk of forfeiture.

Dependent Care Assistance Plans § 129

An employer may provide a similar flexible spending plan for qualified dependent care expenses. The statutory maximum for this benefit is \$5,000 per year. If Jones designates \$5,000 for child care expenses and \$4,000 for medical expenses, \$9,000 is excluded from her income, saving her \$2,250 of tax if she is in the 25% bracket. (Note: we will later study the dependent care credit, which is an alternate way child care expenses can save tax.)

Tax Effect of Plans

The effect of participating in these plans is to convert nondeductible medical and child care expenses to exclusions that lower the AGI and taxable income. The reduced AGI lowers the itemized deduction phaseout, the exemption phaseout, and other phaseouts measured by AGI. These plans provide significant tax benefits to an employee at little cost to the employer. The employer incurs some administrative costs and risks losing money when they reimburse an employee for large expenses early in the plan year and the employee quits shortly after that.

ASSIGNMENT OF INCOME (Fruits and Trees)

“The fruit is not to be attributed to a different tree from that on which it grew.” *Lucas v. Earl*

A. General Rules

1. Income from Services (*Lucas v. Earl*)

The one who earns income is taxed on it, even if the income is irrevocable assigned to another person.

2. Income from Property (*Helvering v. Horst*)

The owner of property is taxed on the income, even if assigned to another person. If the owner transfers the property (the “tree”), the donee is taxed on income earned after the date of the transfer.

B. Income Assigning Strategies

1. Give Property to Children

Before 2007, parents commonly gave securities to their children so the interest, dividends and capital gains (“unearned income”) would be taxed at the child’s low rates. If the child were under 13, the “kiddie tax” taxed this income at the parent’s rates. However, once the child reached 14, the unearned income was taxed at the child’s low rates. In 2007, Congress increased the age of kiddie tax applicability to children under 19, or under 24 if the child is a full-time student. If a child is between 19 and 23, the kiddie tax will not apply if the child has earned income exceeding 50% of her total support for the year. This change significantly reduces the opportunities to assign income to children.

Even when the kiddie tax applies, the first \$900 of a child’s unearned income is not taxed because of the standard deduction and the next \$900 is taxed at the child’s rate of 10%. Therefore it may still be beneficial for parents to give a child a modest amount of income-producing investments because the first \$1,800 of income is taxed at favorable tax rates.

2. Give Property to Parents

When taxpayers in the 35% bracket send \$10,000 to help support their retired parents, they have to earn \$15,384 to end with the \$10,000 ($\$15,384 \times 65\%$ remaining after tax = \$10,000). Taxpayers should consider giving income-producing property to their parents who will pay much less or perhaps no tax on the income it generates.

If the parents are over 64, no tax is payable on the first \$20,000 of income in 2008. Their standard deduction is \$13,000 (including \$2,100 of extra standard deduction because they are both over 64) and they have \$7,000 for two exemptions. The first \$16,050 of income above \$20,000 is taxed at only 10% and the next \$49,050 of income is taxed at 15%. In addition, if their taxable income does not exceed \$65,100, there is no tax on long-term capital gains through 2010.

3. Keep Highly Appreciated and Sell Loss Trees

When a taxpayer gives appreciated property, the donee pays tax on the appreciation because the donee takes the donor’s basis. When the taxpayer dies, the beneficiaries’ basis will be the FMV on the date of death and no one pays tax on the appreciation. Therefore, a taxpayer should try to give property with only modest appreciation and keep highly appreciated property until death. As we studied earlier, a taxpayer should never donate or die with property that has declined in value. A donee cannot deduct a loss incurred while the property was in the donor’s hands. When a beneficiary inherits property, her basis is the FMV on the date of death, and any decline in value while the decedent owned the stock will be lost.

4. Employ Children in the Family Business

If a parent hires a child to work in the family business, the salary is deductible by the business, provided it is reasonable in relation to the services provided by the child. The kiddie tax only applies to *unearned* income of a child and the child is entitled to a standard deduction for earned income. Therefore the child will not have to pay any income tax on the first \$5,450 she earns. The tax rate is only 10% for the next \$8,025 the child earns. In addition, if the child is under 18, neither the child nor the parent has to pay Social Security or Medicare tax on the earnings.

5. Alimony, Child Support and Property Settlements

As we will study in the next chapter, the financial hardship of a divorce can be reduced by using assignment of income strategies when negotiating alimony, child support, and property settlements.

TAX PLANNING FOR DIVORCING COUPLES

The payor of alimony deducts it as an adjustment and the recipient reports it as income. Child support is neither income to the recipient nor deductible by the paying spouse. The paying spouse negotiates to pay alimony so the payments will be deductible and the recipient spouse negotiates to receive tax-free child support. The paying spouse is usually in a higher tax bracket than the recipient so the couple will save tax if they can agree to characterize some payments as alimony instead of child support. This enables them to shift income from the paying spouse's higher tax bracket to the recipient's lower tax bracket. They can share the tax saved by having the paying spouse pay more to the recipient.

Plan 1: All Child Support

Frank and Bonnie divorced in 2008; they have two young children. Bonnie is a trial lawyer and Frank is a stay-at-home dad who has custody of the children. Bonnie agrees to pay \$80,000 per year in child support, but is unwilling to pay alimony to Frank. Her taxable income is \$250,000 and her tax is \$68,251 at single rates. After paying \$80,000 for child support and \$68,251 of tax, she has **\$101,749** of her \$250,000 taxable income left. Frank has no taxable income so he keeps the entire \$80,000 Bonnie paid him.

Plan 2: Part Alimony

Bonnie will increase the payments from \$80,000 to \$89,500, with \$49,500 designated as alimony and the \$40,000 balance designated as child support. Bonnie deducts the \$49,500 alimony, reducing her taxable income to \$200,500 and her tax to \$51,916. After paying \$89,500 to Frank and \$51,916 tax, she retains **\$109,084** of her \$250,000 income.

Frank is unmarried with dependent children living with him so he is a "head of household" for tax purposes. He has \$49,500 of gross income from which he subtracts \$8,000 for the head of household standard deduction and \$10,500 for three exemptions. His taxable income is \$31,000. The tax at head of household rates is \$4,078. He is entitled to a \$2,000 child tax credit, which reduces his tax to \$2,078. Frank retains \$87,422 of the \$89,500 payment after paying the \$2,078 tax.

To summarize the tax consequences of the two arrangements:

	<u>Bonnie retains</u>	<u>Frank retains</u>
Plan 2 (part alimony)	\$ 109,084	\$ 87,422
Plan 1 (all child support)	- 101,749	- 80,000
tax savings	\$7,335	\$7,422

The revised plan saves them \$14,757 of tax, which their families can use more than Uncle.

This is an example of "assigning income" to a taxpayer in a lower tax bracket to save taxes. Bonnie would have paid tax at the rate of 33% on the \$49,500 she paid to Frank. By assigning it to Frank as alimony, he was taxed on only \$31,000 after subtracting the standard deduction and the exemptions. The first \$11,480 was taxed at 10% and the balance was taxed at 15%. In addition, he received the benefit of \$2,000 of child tax credit that Bonnie could not have used because it was phased out at her income level. The \$2,000 tax credit would have been wasted if Frank had not received some taxable alimony to subtract the credit.

Shifting income from a higher to a lower-bracket taxpayer is an important aspect of tax planning. We will study other examples of shifting income during the course. We have already studied how gifts transfer appreciation from the donor to the donee for tax purposes.

ALIMONY RECAPTURE (EXCESS FRONT-LOADING) § 71(f)

The reasons for the recapture provisions of § 71(f) are explained on 867-868. This handout explains the computation of the amount to be “recaptured.” Only the payments made in the first three “post-separation” years are subject to recapture. After the third post-separation year, the payments can fluctuate up or down any amount without any recapture consequences. See § 71(f)(6) for the definition of a post-separation year. The following example will explain the recapture computation.

Facts: Steve and Jackie divorced in 2007. Their settlement agreement requires Steve to pay Jackie \$153,000 in 2007, \$123,000 in 2008, \$104,000 in 2009 and \$7,000 from 2010 to 2013. If Jackie dies before 2013, he will pay \$3,000 to her estate through 2013.

\$3,000 of each payment that continues beyond her death is a property settlement (PS), not alimony (§ 71(b)(1)(D)). Subtract \$3,000 from each payment to determine the deductible alimony.

2007: \$153,000 payment - \$3,000 PS = \$150,000 deductible alimony

2008: \$123,000 payment - \$3,000 PS = \$120,000 deductible alimony (\$116,000 after adjustment)

2009: \$104,000 payment - \$3,000 PS = \$101,000 deductible alimony

2010 to 2013: \$7,000 payment - \$3,000 PS = \$4,000 deductible alimony

In each year, Steve deducts alimony as an adjustment and Jackie reports alimony as income. For example, Steve deducts \$120,000 in 2008 and Jackie reports \$120,000.

In 2009, the third post-separation year, they calculate the recapture amount as follows:

Step 1: Calculate the amount to be recaptured for the second post-separation year (2008). Subtract 2009 alimony from 2008 alimony and subtract another \$15,000 (a statutory amount). The result is alimony recaptured for 2008. $\$120,000 - \$101,000 - \$15,000$ equals **\$4,000** recaptured for 2008. [Important note: If the third-year alimony is larger than the second year alimony, no alimony is recaptured for the second year. Skip Step 2 and go to Step 3. You will see this situation in problem 2 on the next page.]

Step 2: Next calculate the amount to be recaptured for the first post-separation year (2007). Subtract the \$4,000 alimony recaptured in Step 1 from 2008 alimony to arrive at *adjusted* 2008 alimony. $\$120,000 - \$4,000 = \$116,000$ adjusted 2008 alimony.

Step 3: Add adjusted 2008 alimony and 2009 alimony, then divide the sum by two to arrive at the average alimony for 2008 and 2009. $\$116,000 + \$101,000 = \$217,000 \div 2 = \$108,500$ average for 2008 and 2009.

Step 4: Subtract the average determined in step 3 from 2007 alimony and subtract another \$15,000. The result is alimony recaptured for the 2007. $\$150,000$ 2007 alimony - $\$108,500$ average - $\$15,000 =$ **\$26,500** recaptured for 2007.

The total amount recaptured is **\$30,500** (\$4,000 plus \$26,500).

In 2009, Steve deducts \$101,000 of alimony as an adjustment and reports \$30,500 of recaptured alimony as income. Jackie reports \$101,000 of alimony income and deducts \$30,500 of recaptured alimony as an adjustment.

RECAPTURE PROBLEMS

Lana pays Alan the following amounts pursuant to their divorce decree. In problems 1-6, determine Alan's tax consequences in 2008. Unless otherwise stated, all payments end at Alan's death.

1. 2006: \$85,000
2007: \$105,000
2008: \$15,000
2009 to 2012: \$7,000
She must pay \$5,000 to Alan's estate each year if he dies before 2012.
2. 2006: \$135,000
2007: \$40,000
2008: \$60,000
2009 to 2012: \$20,000
She must pay \$10,000 to Alan's estate each year if he dies before 2012.
3. 2006: \$160,000
2007: \$137,000
2008: \$90,000
2009 to 2012: \$50,000
4. 2006: \$150,000
2007: \$170,000
2008: \$60,000
2009 to 2012: \$50,000
5. 2006: \$50,000
2007: \$100,000
2008: \$200,000
2009 and later: zero
6. 2006: \$100,000
2007: \$85,000
2008: \$70,000
2009 to 2012: \$10,000

For problems 7-9, determine how much alimony, if any, is recaptured and the year in which they report the recaptured amount. Read § 71(f)(6) before you do problems 8 and 9.

7. 2006: \$1
2007: \$1
2008: \$1 million
8. 2006: \$0
2007: \$120,000
2008: \$110,000
2009 to 2010: \$80,000
9. 2006: zero
2007: zero
2008: \$1 million
2009: zero
2010 and later: zero

SOLUTIONS TO RECAPTURE PROBLEMS

Problem 1

\$5,000 payable each year beyond Alan's death is a property settlement; subtract it from each payment to determine the alimony amount.

2006: $\$85,000 - \$5,000 \text{ PS} = \$80,000$ deductible alimony

2007: $\$105,000 - \$5,000 \text{ PS} = \$100,000$ deductible alimony (\$25,000 adjusted after recapture)

2008: $\$15,000 - \$5,000 \text{ PS} = \$10,000$ deductible alimony

2009: $\$7,000 - \$5,000 \text{ PS} = \$2,000$ deductible alimony

Recapture computation:

Step 1: $\$100,000$ 2007 alimony - $\$10,000$ 2008 alimony - $\$15,000 = \$75,000$ recaptured for 2007.

Step 2: $\$100,000$ 2007 alimony - $\$75,000$ recaptured = $\$25,000$ adjusted 2007 alimony

Step 3: $\$25,000 + \$10,000 = \$35,000 \div 2 = \$17,500$ average for 2007 and 2008.

Step 4: $\$80,000$ 2006 alimony - $\$17,500$ average - $\$15,000 = \$47,500$ recaptured for 2006.

A total of **\$122,500** of alimony is recaptured. In 2006, Alan reports $\$10,000$ of alimony income and deducts $\$122,500$ as alimony recapture. Lana deducts $\$10,000$ of alimony and reports $\$122,500$ of recapture income in 2006.

(Note that in 2008, Alan has a $\$122,500$ recapture deduction, but reports only $\$10,000$ of alimony income. Unless he has additional income from other sources, most of the deduction will be wasted.)

Problems 2-9

	<u>2007 Recap</u>	<u>2006 Recap</u>	<u>Total</u>	<u>Alan's Tax Consequences in 2008</u>
2.	0	70,000	70,000	\$50,000 alimony income; \$70,000 recapture deduction
3.	32,000	47,500	79,500	*see solution below
4.	95,000	67,500	162,500	\$60,000 alimony income; \$162,500 recapture deduction
5.	0	0	0	\$200,000 alimony income; no recapture
6.	0	7,500	7,500	\$70,000 alimony income; \$7,500 recapture deduction
7.	0	0	0	no recapture in any year
8.	2007 is the first post-separation year. \$15,000 is recaptured for 2008 and \$17,500 is recaptured for 2007; total recapture in 2009 is \$32,500.			
9.	2008 is the first post-separation year so the payments are \$1 million in 2008 and zero in 2009 and 2010. \$985,000 is recaptured in 2010.			

*Problem 3 solution:

$\$137,000 - \$90,000 - \$15,000 = \$32,000$ recaptured for 2007

$\$137,000$ second year payment - $\$32,000$ recaptured = $\$105,000$ adjusted 2007 alimony

$\$105,000 + 2008 \text{ alimony of } \$90,000 = \$195,000 \div 2 = \$97,500$ average 2007 and 2008 alimony

$\$160,000$ 2006 alimony - $\$97,500$ average - $\$15,000 = \$47,500$ recaptured for 2006

Total recapture in 2008 is **\$79,500**.

In 2008, Alan has $\$90,000$ of alimony income and a $\$79,500$ recapture deduction.

In 2008, Lana has a $\$90,000$ alimony deduction and reports $\$79,500$ of recapture income.

CHILD SUPPORT

When the payor is in a higher tax bracket than the recipient, a couple can save tax by characterizing some payments as alimony instead of child support. For many years, taxpayers attempted to “disguise” payments that were essentially nondeductible child support as deductible alimony.

This strategy won support from the Supreme court in *Commissioner v. Lester*, discussed on casebook page 867. In *Lester*, the husband agreed to pay his ex-wife \$10,000 of alimony each year for ten years, but no child support. If their child died or married, the payments were reduced to \$6,000 per year; all payments ended at the time of the wife’s death. \$4,000 of the payments that ended on the child’s death or marriage seemed intended for the benefit of the child and therefore might be child support. The Supreme Court held that the agreement did not “fix” an amount for the benefit of the child under § 71(c)(1) so the entire \$10,000 payment was deductible alimony. Taxpayers used “Lester” agreements to save tax. The amount that the payments were reduced when the child turned 18 or married was essentially child support, but was deductible as alimony.

Congress added § 71(c)(2) in 1984 to reverse *Lester*. Section 71(c)(2)(A) applies when the agreement provides that the payments are reduced upon a contingency relating to the child. If the agreement does not mention the child, but payments are reduced on specified dates, § 71(c)(2)(B) classifies some payments as child support (depending on the ages of the children on the reduction dates). Regs. § 1.71-1T(c), A-18, explains this provision and sets forth two situations when reductions in payments are *presumed* to be child support.

We will only consider the first situation: When the payments are reduced within six months before or after any child becomes 18-years-old, the amount of the reduction is presumed to be child support.

Example

Nate pays Rachael the following amounts pursuant to their settlement agreement. If Rachael dies before 2014, all payments end except \$5,000 per year that he will pay to Rachael’s estate. Rachael has custody of their child Evan, who was born on March 14, 1993.

2004 - 2007: \$40,000

2008 - 2010: \$32,000

2011 - 2014: \$14,000

Step 1: Determine how much of each payment is a property settlement (PS).

\$5,000 continues after Rachael’s death so \$5,000 is considered a property settlement each year.

Step 2: Determine how much of each payment is child support (CS).

Determine when each child becomes 18 and see if the payments are reduced within six months before or after a child’s 18th birthday. Evan becomes 18 on March 14, 2011, which is within six months before or after the payments are reduced by \$18,000 on January 1, 2011. \$18,000 is presumed to be child support until 2011, the year Evan becomes 18. The tax status of these payments is as follows:

2004 - 2007: \$40,000 payment - \$5,000 PS - \$18,000 CS = \$17,000 of alimony

2008 - 2010: \$32,000 payment - \$5,000 PS - \$18,000 CS = \$9,000 of alimony

2011 - 2014: \$14,000 payment - \$5,000 PS = \$9,000 of alimony

Step 3: Determine how much alimony must be recaptured.

The alimony payments were \$17,000 in each of the first three post-separation years, so there is no recapture.

ADDITIONAL PROBLEMS

Problem 1

Tony and Nancy were married in 1988 and had one daughter born on December 18, 1998. They were divorced in 2006 and Tony was awarded custody of their daughter. The court ordered Nancy to make the following cash payments to Tony. All payments terminate on his death, except \$5,000 that will continue to be paid to his estate. What are the tax consequences **in 2008**?

2006: \$205,000

2007: \$215,000

2008: \$55,000

2009 through 2016: \$25,000 per year

2017 through 2022: \$15,000 per year

Problem 2

Jamie purchased Ha-Lo stock for \$7,000.

- (a) She gave the stock to her husband Oscar when it was worth \$3,000. What is Oscar's gain or loss when he later sells it for \$1,000?
- (b) Instead of giving it to Oscar, she gave it to her son Arthur who later sold it for \$1,000; what is Arthur's gain or loss?
- (c) Instead of *giving* it to Oscar, she *sold* it to him for its \$3,000 fair market value. What is Oscar's gain or loss when he later sells it for \$1,000?

SOLUTION TO CHILD SUPPORT PROBLEM 1

Step 1: Subtract payments that continue after death, are not in cash, or are specifically designated as child support. The \$5,000 that continues after her death is a property settlement (PS) and is subtracted from each payment. The remaining amounts are \$200,000, \$210,000 and \$50,000.

Step 2: Their daughter becomes 18 on 12/18/2015 and the payments are reduced by \$10,000 within six months after that date. \$10,000 of each payment is child support (CS) until 2016, when the payments are reduced to \$15,000. Beginning in 2016, \$5,000 of each payment is a property settlement and \$10,000 is alimony.

2006: $205,000 - 5,000 \text{ PS} - 10,000 \text{ CS} = 190,000$ alimony

2007: $215,000 - 5,000 \text{ PS} - 10,000 \text{ CS} = 200,000$ alimony

2008: $55,000 - 5,000 \text{ PS} - 10,000 \text{ CS} = 40,000$ alimony

2009 through 2016: $25,000 - 10,000 \text{ CS} - 5,000 \text{ PS} = 10,000$ alimony

2017 through 2022: $15,000 - 5,000 \text{ PS} = 10,000$ alimony

Step 3: Determine how much alimony must be recaptured.

Recapture for the second year

$200,000 - 40,000 - 15,000 = \underline{145,000}$ recaptured for the second year

$200,000 - 145,000 = 55,000$ adjusted second year payment

$55,000 \text{ adjusted second year payment} + 40,000 \text{ third year payment} = 95,000 \div 2 = 47,500$ average

Recapture for first year: $190,000 - 47,500 \text{ average} - 15,000 = \underline{127,500}$

Total recapture: $145,000 + 127,000 = \underline{\underline{\$272,500}}$

In 2008 Nancy deducts \$40,000 of alimony and reports \$272,500 of recapture income. Tony reports \$40,000 of alimony income and deducts \$272,500 of recapture as an adjustment.